

DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

## **GUATEMALA**

### **FINANCIAL SECTOR REFORM PROGRAM II**

(GU-0119)

### **LOAN PROPOSAL**

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**ABBREVIATIONS**

<b>BCPS</b>	<b>Basel Core Principles</b>
<b>FATF</b>	<b>Financial Action Task Force</b>
<b>GDP</b>	<b>Gross Domestic Product</b>
<b>GGU</b>	<b>Government of Guatemala</b>
<b>IFF</b>	<b>Intermediate Financing Facility</b>
<b>IMF</b>	<b>International Monetary Fund</b>
<b>LB</b>	<b>Liquidation Board</b>
<b>LOLR</b>	<b>lender-of-last-resort</b>
<b>MB</b>	<b>Monetary Board</b>
<b>ML</b>	<b>Money Laundering</b>
<b>OAS</b>	<b>Organization of American States</b>
<b>OVE</b>	<b>Office of Evaluation and Oversight</b>
<b>PCR</b>	<b>Project Completion Report</b>
<b>RR</b>	<b>reserve requirements</b>
<b>SB</b>	<b>Superintendency of Banks</b>



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## IDB LOANS

APPROVED AS OF SEPTIEMBRE 30, 2001

	US\$ Thousand	Percent
<b>TOTAL APPROVED</b>	<b>2,187,858</b>	
DISBURSED	1,724,475	78.8%
UNDISBURSED BALANCE	463,382	21.2%
CANCELLATIONS	219,414	10.0%
PRINCIPAL COLLECTED	713,486	32.6%
<b>APPROVED BY FUND</b>		
ORDINARY CAPITAL	1,499,560	68.5%
FUND FOR SPECIAL OPERATIONS	628,192	28.7%
OTHER FUNDS	60,106	2.7%
<b>OUTSTANDING DEBT BALANCE</b>	<b>1,010,990</b>	
ORDINARY CAPITAL	604,334	59.8%
FUND FOR SPECIAL OPERATIONS	399,659	39.5%
OTHER FUNDS	6,997	0.7%
<b>APPROVED BY SECTOR</b>		
AGRICULTURE AND FISHERY	180,772	8.3%
INDUSTRY, TOURISM, SCIENCE TECHNOLOGY	210,545	9.6%
ENERGY	276,902	12.7%
TRANSPORTATION AND COMMUNICATIONS	436,906	20.0%
EDUCATION	65,628	3.0%
HEALTH AND SANITATION	301,714	13.8%
ENVIRONMENT	59,100	2.7%
URBAN DEVELOPMENT	177,589	8.1%
SOCIAL INVESTMENT AND MICROENTERPRISE	240,533	11.0%
REFORM PUBLIC SECTOR MODERNIZATION	236,404	10.8%
EXPORT FINANCING	1,764	0.1%
PREINVESTMENT AND OTHER	0	0.0%

\* Net of cancellations with monetary adjustments and export financing loan collections



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## TENTATIVE LENDING PROGRAM

US\$ Millions

<b>2001</b>			
GU0160	PEF; GU0155 URBAN POVERTY COMBAT PROGRAM	0.4	APPROVED
GU0161	PEF; GU0152 SUPPORT INTERNATIONAL TRADE	0.3	APPROVED
GU0152	FOREIGN TRADE SUPPORT PROGRAM	5.0	APPROVED
GU0131	SUPPORT TO EDUCATION REFORM II	22.0	APPROVED
GU0119	FINANCIAL SECTOR REFORM PROGRAM II	200.0	
	<b>TOTAL A</b>	<b>227.7</b>	
GU0151	CAPITAL EXPEN. ELECTRICITY DISTRIBUTION	35.0	
	<b>TOTAL B</b>	<b>35.0</b>	
	<b>TOTAL 2001</b>	<b>262.7</b>	
<b>2002</b>			
GU0133	PRIORITY BASIN NATURAL RESOURCES	40.0	
GU0066	SANITATION & SUST. MGMT. AMATITLAN BASIN	21.0	
GU0150	RURAL WATER INVESTMENT PROGRAM	50.0	
	<b>TOTAL A</b>	<b>111.0</b>	
GU0158	JOB MARKET PROGRAM	10.0	
GU0155	INTEGR. PROGR. AGAINST URBAN POVERTY	60.0	
GU0143	MODERNIZATION OF NATIONAL CONGRESS	12.0	
GU0154	MICROCREDIT GLOBAL PROGRAM	20.0	
GU0126	TRANSMISSION AND RURAL ELECTRIFICATION	95.0	
GU0159	TRAINING AND LITERACY WORKSHOPS	10.0	
GU0157	SUPPORT POV. RED. STRAT IMPLEMENTATION	30.0	
GU0163	CITIZEN SECURITY	30.0	
GU0165	ELECTORAL SUPREME TRIBUNAL MODERNIZATION	6.0	
GU0164	NAC. SYS. SERVICES AND GOODS CONTR. SUPP	6.5	
	<b>TOTAL B</b>	<b>279.5</b>	
	<b>TOTAL 2002</b>	<b>390.5</b>	



INTER-AMERICAN DEVELOPMENT BANK  
Regional Operations Support Office  
*Operational Information Unit*

# GUATEMALA

## STATUS OF LOANS IN EXECUTION AS SEPTEMBER 30, 2001

(Amounts in US\$ thousands)

APPROVAL PERIOD	NUMBER OF PROJECTS	AMOUNT APPROVED	AMOUNT DISBURSED	% DISBURSED
Before 1995	5	99,100	88,371	89.17%
1995 - 1996	5	160,455	100,882	62.87%
1997 - 1998	8	279,010	148,060	53.07%
1999 - 2000	4	235,672	7,515	3.19%
2001	3	31,500	0	0.00%
<b>TOTAL</b>		<b>\$805,737</b>	<b>\$344,829</b>	<b>42.80%</b>

\* Net of Cancellations . Excluding export financing loans.

## FINANCIAL SECTOR REFORM PROGRAM II

(GU-0119)

### EXECUTIVE SUMMARY

<b>Borrower and executing agency:</b>	Republic of Guatemala		
<b>Amount and source:</b>	IDB:	US\$	200 million
	OC	US\$	138 million
	OC/IFF	US\$	62 million
(US\$62 million of the first disbursement would have the interest rate reduced by the Intermediate Financing Facility)			
<b>Financial terms and conditions:</b>	Amortization Period:	20	years
	Grace Period:	5	years
	Disbursement Period:	2.5	years
	Interest Rate:	variable	
	Supervision and Inspection:	1.0	%
	Credit Fee:	0.75	%
	Currency:	US dollars from the single currency facility	
<b>Objectives:</b>	The objective of the proposed operation is to modernize the legal framework of the financial sector and to strengthen the regulatory and supervisory entities of the system, in particular the central bank and the superintendency of banks.		
<b>Description:</b>	The Program consists of a series of legal reforms, the issuance of regulations that are required by the legal reforms, and the implementation of action plans to enable the authorities to execute the reforms. The Program will be executed by the Government of Guatemala with the participation of the Ministry of Public Finance, the Central Bank and the Superintendency of Banks. In parallel, the Bank is preparing a technical cooperation program with the Superintendency of Banks and Guatemala is implementing a macroeconomic stabilization program, which will be monitored by the International Monetary Fund		
<b>Bank's country and sector strategy:</b>	The strategy of the Bank towards the financial sector in Guatemala has been focused on helping the Government create the circumstances that would enable an ambitious program of reforms		



to be successfully adopted and implemented. To implement this strategy the Bank has supported a comprehensive series of diagnostic studies of the legal, regulatory and supervisory frameworks in the financial sector. In addition, the Bank has participated in, financed or otherwise supported the dissemination of the findings of these diagnostic studies **through** seminars and other events. **As** a result of these activities, there is now a shared understanding of the need for reform in this important area along with the political will to undertake the measures to make the reforms a reality. The new Bank strategy for Guatemala, approved in September 2001, calls for support to continue to be provided to the financial sector.

**Environmental/  
social review:**

Because the activities of the program are directed at legal and institutional reforms in the financial sector, the operation is not expected to have negative social or environmental impact.

**Benefits:**

The institutions that are the focus of this program, the central bank and the superintendency of banks, are technically strong. However, because of weaknesses in the legal framework they have not been able to fully exercise their technical strengths in the implementation of monetary and exchange policy or in the regulation and supervision of the banking sector. The new legal framework supported by the proposed program provides these institutions with the firm legal foundation that they need to accomplish their functions. It is expected that this will contribute to a safer and sounder financial system and one that is more competitive and efficient.

**Risks:**

The composition of the Monetary Board, the body that oversees the activities of the Central Bank and the Superintendency of Banks, presents a political risk to the reforms. The executive branch, the Congress and business interests are represented on this Board. This has given rise to political criteria being used instead of technical criteria in the taking of some important decisions. Since the composition of the Board is determined by the Guatemalan constitution, it has not been changed by the proposed program. Nonetheless, the provisions of the new legal framework, particularly the devolution of sanctioning powers to the SB, the increased independence of the central bank and the more clearly delineated framework for the implementation of monetary policy, should make it easier for the authorities to take actions on technical and not on political grounds.

Related to this is the problem of judicial security. The reform measures should reduce judicial arbitrariness by making the rules of the game more clear and by eliminating several loopholes.

<b>Special contractual clauses:</b>	The Program will be disbursed in two tranches. A first tranche of US\$120m will be available for disbursement upon the enactment of the legal framework supported by the operation and the approval of the Program by the Bank. The second tranche, for US\$80m, will be available when the new legal framework has been fully implemented. (The policy matrix, Annex I, contains full details of the disbursement conditions.)
<b>Procurement:</b>	Does not apply. See paragraphs 4.3 to 4.5.
<b>Poverty-targeting and social equity classification:</b>	This operation does not qualify as a poverty targeted/social equity enhancing project, as described in the targets mandated by the Bank's Eighth Replenishment (document AB- 1704).
<b>Exceptions to Bank policy:</b>	None

## **I. BACKGROUND**

### **A. Overview**

- 1.1 In 1993 the Government of Guatemala (GGU) began a process of reform in the financial sector with a series of measures that were directed at increasing the supply of loans from banks to the productive sectors and at improving competition among banks. Specific measures approved at that time freed interest and exchange rates, expanded the scope of operations that banks were permitted to carry out, and increased the capital banks were required to have. Also, during this time a major legal reform was initiated with the drafting of a new banking act. The Bank supported this reform with the Program to Modernize the Financial Sector (GU-0118).
- 1.2 These initial financial sector reforms have been implemented and the Government has requested the Bank to complement them by supporting a program of “second generation” reforms. The requested program takes the draft of the new banking act that was prepared during the earlier operation and elaborates it into a completely new legal framework for the banking sector, the first major reform of the country’s bank legislation since 1946. The program would be accompanied by a macroeconomic stabilization program, to be monitored by the International Monetary Fund (IMF)<sup>1</sup>. Separately, a MIF-financed technical cooperation operation is being prepared. The TC will help the Superintendency of Banks (SB) draft the regulations that are required by the new banking legislation and train the SB in the methods of consolidated supervision that is mandated by the new legal framework. The TC has been declared eligible by the MIF and the Donors Memorandum is being prepared.
- 1.3 The World Bank is preparing a structural adjustment loan in parallel with the proposed operation. It supports activities related to the resolution (ie restructuring, intervention or liquidation) of problem banks. The amount of the WB loan is expected to be between US\$150 and US\$200m. These efforts of the GGU along with the financial and technical support that is being provided by the multilateral institutions, are expected to substantially improve the safety and soundness of the Guatemalan financial sector.

### **B. The context of the Program**

- 1.4 Despite some improvement in economic performance and structural reforms since the early 1990s, Guatemala continues to face serious problems of poverty and income distribution. Nearly 60 percent of the population lives below the poverty line, while the top quarter of the population enjoys about 95 percent of national income. The 1996 Peace Accords set an economic and social agenda to address

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<sup>1</sup> The Government has requested a stand-by program from the IMF. Both the Government and the IMF are confident that they will be able to put a program in place late this year or early in 2002. In the event that a stand-by program is not possible in this time frame, an IMF staff-monitored program will be put in place.

this ingrained inequality in income and the institutional failures and social barriers that cause these distortions. The Accords contemplate a substantial increase in public investment in social and basic infrastructure to be financed by higher tax revenue and through increased donor support.

- 1.5 Since 1993 Guatemala has been implementing structural policy reforms that were designed to increase economic growth, reduce poverty and reduce macroeconomic imbalances. The reforms included measures that liberalized the trade and exchange rate regimes along with fiscal and monetary policies that reflected these liberalizing moves. Partially **as** a result of these measures tax collections rose from 7.9 percent **of** Gross Domestic Product (GDP) in 1995 to 8.7 percent of GDP in 1996 and the combined public sector balance reached equilibrium. Inflation dropped to single digits and the external current account deficit fell to 3.5 percent of GDP.
- 1.6 However, fiscal and monetary policies were relaxed in 1997 and these achievements began to unravel. Expansive monetary policy led to a boom in banking credit, while public expenditures also surged causing real GDP growth to accelerate to 5 percent. In addition, since the financial sector liberalization measures were not accompanied by a strengthening of the legal and regulatory framework of the sector, the economic growth came at the cost of increased risks in the financial system. The system was ill-prepared to withstand external or internal shocks. The combination in 1998 of Hurricane Mitch, the turmoil in international financial markets, and the bankruptcy of the three largest coffee traders caused a financial sector crisis that is still being played out. Inadequate policy responses resulted in a loss of public confidence, large capital flight, and a sizable depreciation of the currency.
- 1.7 Since assuming office in January 2000, the administration **of** President Alfonso Portillo has sought to restore macroeconomic stability and advance the implementation of the Peace Accords. Budgeted public expenditures were cut and a tight monetary policy was implemented. Capital began to flow back into Guatemala stabilizing the exchange rate while inflation was held at a moderate level. GDP growth slowed slightly to 3% in 2000 (compared to 3.5% in 1999) and the external current account deficit narrowed to **4%** percent of GDP in 2000 (5% percent in 1999) owing to the conservative fiscal and monetary policy, as well as the lagged effect of the real quetzal depreciation in 1999. The capital account surplus rose to 8% percent of GDP in 2000 as a result of private capital inflows attracted by high domestic interest rates and the receipt of the second installment from the privatization of the state telecommunication company.
- 1.8 As mentioned the fiscal situation improved during 2000. In fact, the overall deficit **of** the combined public sector fell to **2%** percent of GDP (3 percent of GDP in 1999) due to an increase in tax revenue and a reduction in fiscal expenditures. Tax revenue rose slightly to 9.6 percent of GDP (9.3 percent in 1999) reflecting

the effect of tax measures introduced in June 2000<sup>2</sup> along with some improvement in tax administration. Public expenditures fell **as** a result of a reduction in central government capital outlays of almost 21 percent. This was partially offset by an increase of **16.5** percent in current expenditures (associated with a 10 percent across-the-board increase in wages), a higher interest bill (much of this from an increase in open market operations), and the cost of the subsidy on electricity consumption. However, in spite of these overall improvements, the fiscal situation remained fragile, as the main tax measures included in the Fiscal Pact approved in June 2000 were not implemented.

- 1.9 The fiscal situation deteriorated markedly in the first semester of 2001, as economic growth decelerated and public spending expanded. This prompted the authorities to propose strong fiscal measures that were eventually approved in July. The measures, which include a VAT increase from 10% to 12%, a new tax code, and stronger collection enforcement mechanisms, should raise the tax ratio to around 11% of GDP in 2002, and allow for a decrease in the overall public deficit from the projected level of about 2.7 % of GDP in 2001. Simultaneously, the current account deficit is expected to remain around 4.5% of GDP in 2001 and beyond, while the authorities ~~try~~ to hold the level of international assets near their present level.
- 1.10 The central bank has maintained a tight monetary policy since August 1999. In early 2000, the central bank stepped up its placement of open market securities. This conservative policy improved confidence and there was a net capital inflow which prompted an increase in the international reserve position from **US\$1.2b** at the end of 1999 to US\$1.8b in August of 2001 (**117% of** base money). This tighter monetary policy also helped to reduce the annual growth in credit to the private sector from above 20% in August 1999 to a more sustainable level **of** slightly less than 10% in the following period until August 2001.
- 1.11 The financial sector remains fragile, a result of a history of inadequate prudential regulations and supervisory powers. Non-performing loans stood at 12.5 percent of total loans at end-2000, with a substantial under-provisioning for credit risks. Capital adequacy ratios and profitability have also deteriorated. The existence of an active and extensive unregulated banking sector tied to the regulated institutions hides the true size of the problems and makes their solution more difficult. These unregulated entities, mainly offshore banks and some unconsolidated onshore institutions, carry on a level of financial intermediation in Guatemala that may be as large **as** that carried out by the regulated entities.
- 1.12 The authorities are concerned about these problems and are taking strong measures to address them. In early 2001, the Monetary Board intervened three insolvent banks and one finance company and it drafted five new laws for the

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<sup>2</sup> Such measures included: increasing the top income tax rate from 25 percent to 31 percent; widening the VAT base to include customs duties; and phasing out some exemptions.

financial sector, which, when passed, will substantially improve the legal framework for monetary policy, bank supervision and regulation.<sup>3</sup>

- 1.13 The securities market:** There is a market for government securities in Guatemala. These securities are traded by 28 broker/lenders on two exchanges. In addition, until 1998 there was a market for private sector debt. The collapse of the coffee traders, mentioned in paragraph 1.6, caused these and related companies to default on their debts and triggered a collapse of the market that revealed a pattern of abuses on the part of issuers and some brokers. In addition, there was much dis-intermediation, with banks booking transactions in their broker/dealer affiliates in order to avoid reserve requirements or to evade the scrutiny of the SB. This market has not shown signs of re-emergence in the years since its collapse.
- 1.14** Since the amount of deposits in the banking system is far greater than the estimates of what could be invested in securities issued by private companies, the banking system presents greater risks to the economy and Guatemala's fiscal stability. Similarly, repairing the damage that has been done to the banking system offers a far greater benefit to the economy than does the reconstruction of the capital market. Furthermore, the addition of complicated securities legislation to the package of banking legislation could jeopardize the approval of the latter. For this reason the government's reform strategy is focussed on the banking sector. Nonetheless, the Bank is working with the authorities on some reforms that could create conditions appropriate for a re-emergence of the capital market. While no decision has been reached yet, these reforms could be considered later, after the banking reforms are passed and their implementation has begun.
- 1.15 Money laundering:** During the preparation of the proposed Program Guatemala was placed on the list of non-cooperative countries by the Financial Actions Task Force (FATF). The determination to place Guatemala on this list was based on an analysis of the existing banking and other laws and did not therefore reflect all of the actions that the Government is taking to solve the problem of money laundering. The initiatives of the Government had begun before the FATF report and continue. The more strict measures of prudential control that are reflected in the banking sector laws that this operation is supporting are an important part of this process. The actions that the Government is taking in this regard, including the recent passing of the Money Laundering Act, are described in section V.

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<sup>3</sup> The new legal framework consists of the Organic Law of the Bank of Guatemala, the Monetary Act, the Free Negotiation of Foreign Exchange Act, the Banking and Financial Groups Act, and the Financial Supervision Act.

### **C. Bank strategy and justification**

- 1.16 The preparation of the proposed program was guided by the Bank's country strategy (GN-1924) that had been approved in 1996. The strategy calls for the Bank to focus its support to Guatemala in four main areas. One of these is the modernization of the state. The Bank's activities to reform the financial sector fall in this area.
- 1.17 The strategy calls for the Bank to undertake the background studies that would lead to a deepening of the reforms that were begun with the first financial sector reform program. The strategy also calls for these studies to be used to support the preparation of a new financial sector program.
- 1.18 Since that time, the Government of Guatemala and the IDB have been exploring options to develop a program of second generation reforms of the financial system. In accordance with the policy the Bank supported diagnostic studies of the legal, regulatory and supervisory frameworks in the sector. In the past, the lack of internal support for banking sector reforms, particularly the legal reforms that would lead to improved bank regulation and supervision, made it difficult to develop a program. To help develop the public and political support necessary for the reforms to be passed, the Bank has participated in, financed or otherwise supported the dissemination of the findings of these diagnostic studies through seminars organized by the Bank of Guatemala and the Superintendency of Banks. As a result of these efforts, there is now a shared understanding of the need for reform in this important area along with the political will to undertake the measures to make it happen.
- 1.19 In September 2001 the Bank approved a new country strategy for Guatemala. The new strategy calls for the Bank to continue supporting the modernization and strengthening of the financial sector.
- 1.20 The proposed Program is justified from an economic and a policy point of view. The net external debt necessary to finance the fiscal and current account deficits is expected to increase by 1.0% of GDP in 2001 and by 1.4% in 2002. The GDP expected for 2001 is around US\$20b, so the net external financing requirements are expected to be between US\$200m and US\$300m for each year.
- 1.21 Macroeconomic and banking sector policies need to be changed to restore fiscal balance and to avoid large deficits in the future. The proposed program contains components in both of these important policy areas that are described in Section III.

### **D. Lessons learned**

- 1.22 In a report prepared in November 1999 entitled "Evaluation of the Policy-Based Loan Portfolio – Phase III", the Office of Evaluation and Oversight (OVE) set out a series of recommendations for the preparation of sector loans. The main

findings related to financial sector programs are related to the nature of second generation reforms. The OVE report states that, “With the first generation of financial sector loans, the Bank provided significant support for liberalization, privatization and greater competitiveness in the financial systems of various countries of the region. Today, in some of these countries at least, there would appear to be a need for a second generation of financial reforms aimed at: (1) reinforcing systems of regulation, supervision, supply and disclosure of information on the quality of assets and the capital adequacy of financial entities; (2) reining in the excess credit expansion that results from inadequate evaluation of the risks involved; (3) restricting the practice of related-party lending and (4) achieving the institutional harmonization of the new, freer and more varied instruments and institutions that now exist.”

- 1.23 These recommendations are appropriate in the case of the proposed program and they have been followed closely. The first generation of reforms focussed on financial liberalization and improving competition. The first generation also initiated the process of a more substantial reform with the drafting of a banking law that has served as the starting part for the reforms that are the objective of the proposed Program.
- 1.24 Additionally, the experience of earlier sector loans has shown that it is frequently difficult to mobilize the political support necessary to approve legal reforms that remain as conditions for second or third tranche disbursements. To avoid this problem, the approval of all of the laws in the proposed Program is a condition for the presentation of the Program to the Bank’s Board of Executive Director.



## **II. THE FINANCIAL SYSTEM**

### **A. Description**

- 2.1 The regulated financial system consists of 29 domestic commercial banks, 2 branches of foreign banks, 19 private-sector finance companies, one state-owned finance company, a state-owned mortgage finance company, 8 foreign exchange houses, 18 bonded warehouses, and 18 insurance companies. Banks are by far the largest component of the financial system, accounting for 87 % of the regulated system's total assets. Finance companies are the next largest component, but with only 8 % of total assets. Insurance companies' assets represent 3% of the regulated system's assets. The SB regulates all of these entities.
- 2.2 As mentioned earlier, there are 28 broker dealers on two securities exchanges in Guatemala. They are subject to regulation by the Ministry of the Economy. Their main activities are intermediating the purchase and sale of government securities.

### **B. Banking system**

- 2.3 Total assets in the banking system are only 33% of GDP. The average bank in Guatemala has total assets of only US\$200m. However, these figures understate the true size of the system, since much of the banking activity that occurs within Guatemala is not reflected in the accounts of the regulated banks. Rather, this activity is booked in unregulated domestic subsidiaries of the banks or in the off-shore bank member of a financial group.
- 2.4 The banking sector has grown rapidly in recent years. Total assets in the system grew by approximately 40% between 1996 and 2001. The number of institutions has also grown rapidly, from 16 in 1980 to 32 today. Given the size of the local market and the economies of scale of the banking business, the system is considered to be over-banked. Consequently, the number of banks and finance companies in the system is slowly being reduced through mergers and more recently, as a result of interventions and liquidations.
- 2.5 Most banks in Guatemala are members of an economic group. These groups are organized informally around the commercial bank in the group. The financial companies in each group focus their services on the industrial, and commercial companies that are members of the group.
- 2.6 Deficiencies in the legal framework did not provide an adequate control on related-party lending with the result that abuses were common. The capital of some banks was too small to cover the resulting risks and the system as a whole was unprepared to withstand the kind of external shocks that occurred in 1998 when three coffee traders went bankrupt, causing many finance companies to fail.
- 2.7 The aftershocks of this have continued to ramify through the system. In 1999 eight banks required official assistance in order to meet maturing obligations.

These institutions entered into restructuring programs with the Monetary Board that obliged them to increase capital and reserves and to reduce their risk-taking activities. Three of these banks executed their restructuring programs and repaid the loans. Three others were unable to implement their restructuring programs and could not repay the loans. They were intervened by the Monetary Board during the first quarter of 2001. Although deposit insurance in Guatemala is limited to 420,000 (about US\$2,500), the authorities have been obliged to take responsibility for substantially all of the deposits (except for the deposits of parties related to the owners and managers of the intervened banks) in order to prevent these banks' problems from spreading to other institutions.

## **1. The legal framework before the 2001 Reform**

- 2.8 **The General Structure:** The Constitution (articles 132 and 133) calls for a legal, regulatory and supervisory framework for the financial sector that consists of a central bank (the Bank of Guatemala, "BANGUAT"), a bank superintendency, and a monetary board. The Monetary Board (MB) sits at the top of this system. The Constitution makes the **MB** responsible for "the development of monetary, exchange and credit policy; for the liquidity and solvency of the banking system; and for strengthening national savings."
- 2.9 The Constitution sets out the membership of the **MB**. It has eight members. The president of the Bank of Guatemala is ex-officio the president of the **MB**. The other members are: the ministers of finance, economy, and agriculture; a member of the national Congress, a representative from the business associations; a representative from the banking sector; and a representative from the University of San Carlos.
- 2.10 **Central Bank Powers:** In Guatemala the central bank has not been able to act in a wholly independent manner, for several reasons. As stated earlier the Constitution specifies that the MB, not BANGUAT, is responsible for the development of monetary, exchange and credit policy. In addition, the composition of the MB limits the central bank's independence since the central government and the private sector are strongly represented on the Board.
- 2.11 The lack of a clear goal for the central bank has also hindered the development of an independent monetary policy. The earlier Bank of Guatemala Act assigned to BANGUAT the goal of "promoting the creation and maintenance of monetary, exchange and credit conditions favorable to the orderly development of the economy." Another part of the act required BANGUAT to maintain a stable exchange rate. While such goals are laudable, they are imprecise and depart from the more modern tendency of stating a central bank's goal as "preserving price stability", or something similarly clear and unambiguous.
- 2.12 The law and regulations regarding reserve requirements (RRs) lacked precision and were difficult to implement. Banks were required to maintain RRs against "deposits and similar obligations". This gave rise to disputes as to what was

“similar” enough to be subject to RRs and what was not. The reserve period was 30 days, too long to enable BANGUAT to adjust liquidity temporarily for seasonal reasons. Even more important was the fact that BANGUAT lacked the sanctioning power necessary to force compliance with the RR. As a result banks often held inadequate reserve levels at the central bank, or fell into overdraft.

- 2.13** The previous Bank of Guatemala Act contained no provisions to transfer the costs of monetary and exchange policy to the Government. Uncompensated losses accumulated in BANGUAT, creating a negative net worth of approximately **8%** of GDP. Most of these losses were related to the execution of monetary policy, where the sale of BANGUAT notes to banks to contract the money supply caused BANGUAT to incur high interest expense.
- 2.14** Inadequately regulated lender-of-last-resort (LOLR) facilities and the inappropriate use of government deposits have disfigured the bank resolution framework. The old legislation gave the MB excessive discretion in granting liquidity assistance to banks. Furthermore, the legislation did not set any limit on the amount of BANGUAT liquidity loans that could be granted to banks, it allowed unduly long maturities for these loans (up to three years in the case of the so-called emergency advances), and left the setting of the interest rate to the discretion of the MB. This distorted the resolution framework as the MB sometimes provided LOLR support to insolvent institutions. This situation was complicated by an erratic management of the bank deposits of government companies and trust funds whose resources would be mobilized to support a favored institution only to be withdrawn abruptly later when other needs were perceived. This lack of independence, combined with some deficiencies in the law, has tended to make it difficult for the authorities to take corrective actions. The recent interventions occurred after the institutions had become insolvent and too late for corrective actions.
- 2.15 Regulation and Supervision:** Bank regulation has been ineffective due to deficiencies in the law. Until recently the Superintendency of Banks and the **MB** lacked the legal powers to regulate in many areas that are essential for ensuring good prudential oversight. For instance, the authorities could not control significant changes in the ownership of banks, apply “fit-and-proper” standards; enforce the establishment of loan loss provisions; or impose penalties on banks and/or bank administrators. Even when legal powers were adequate, these entities frequently encountered enforcement problems due to weaknesses in the judicial system. As a result of these legal deficiencies a permissive environment was created in which bank shareholders could openly own non-regulated intermediaries and book banking transactions off the balance sheet of the bank to avoid the legal reserve requirement, to hide problem loans or to accommodate clients who desired bank secrecy. The lack of personal security and a fear of being kidnapped create additional incentives for a large offshore sector protected by high levels of bank secrecy. Lastly, the natural conflict of interests embedded in the composition of the MB led to a decision-making process in that body that

could be dominated by special interests when decisions needed to be made concerning the application of banking regulations.

- 2.16 The authorities were unable to supervise or even to obtain information concerning a financial group's unregulated financial intermediaries. The bulk of the activity of these unregulated entities is taking dollar-denominated deposits (or quasi-deposits) from, and making dollar-denominated loans to, Guatemalan residents. Several experts estimate that the amount of financial assets held in unregulated financial institutions (including both domestic entities and offshore banks) is equal to the assets in the regulated system. While regulated and unregulated entities are part of *de-facto* financial conglomerates, the lack of consolidated supervision and the consequent lack of information regarding the unregulated segment add unnecessarily to the risks in the financial system and frustrate the conduct of monetary policy.
- 2.17 Banks have not recognized loan losses adequately, mainly due to deficiencies in prudential regulations and in the enforcement capacity of the SB. Banks have avoided the constitution of loan-loss provisions required by the SB by using appeals and by resorting to "due process" arguments. There were no general provisions to cover the portion of the banks' good assets that eventually become impaired, only specific provisions for loans that have been classified as sub-standard or worse. Provisions were applied to the loans net of guarantees, but the latter are often overvalued. Penalties for noncompliance with loan classification and provisioning requirements were inadequate.
- 2.18 The regulation and control of lending to related parties were flawed. Legal reforms initiated in September 1999 introduced tighter limits (**40%** of a bank's capital) on loans to related parties. However, since the SB's power to identify related parties was very circumscribed, these limits could not be enforced..
- 2.19 Provisions in the Banking Act for prompt corrective action were inadequate. The systems for early correction was weak, as there was no framework to require regularization plans or to apply enhanced supervision of troubled banks. Enforcement powers, including cease and desist powers and the powers to levy fines were lacking. The process of judicial liquidation was legally insecure—the judge could rule against a petition of the MB to intervene or to liquidate an institution or the bank's shareholders could stall or reverse the process by introducing a *recurso de amparo* in the courts.
- 2.20 **As** a result of all of the above, compliance with the Basel Core Principles (BCPs) is very low. Of the **30** BCPs, Guatemala did not comply with 28 (11 fully non-compliant, and 17 partially non-compliant). **No** BCP was found to be fully complied with, while only **2** were even partially complied with. The authorities are cognizant of this situation. Their self-assessment of compliance with the BCP coincides broadly with the assessment made recently by the World Bank and the **IMF**.

- 2.21 Given the absence of adequate systems of intensified supervision, regularization plans, and other kinds of prompt corrective actions which would enable the **MB** and the **SB** to remove bank administrators, intervention has been used as a belated stage to investigate the solvency situation of the bank and to decide whether the **MB** should consider asking a judge to declare a state of bankruptcy. This environment fueled moral hazard, and exposed the BANGUAT to large losses.

## **2. The legal structure after the Reforms**

- 2.22 **The General Structure:** The Constitution has not been amended so the figure of the **MB** remains the same in the new legal framework. However, the laws have been modernized considerably to provide the authorities with the powers that they require to conduct monetary policy and to ensure the safety and soundness of the financial system. The new legal framework is contained in five laws. Three of these are directed at central banking activities. They are the Organic Law of the Bank of Guatemala, the Monetary Law and the Free Negotiation of Foreign Exchange Act. The other two affect bank regulation and supervision. They are the Banking and Financial Groups Act and the Financial Supervision Act.
- 2.23 **Central Bank Powers:** The new Bank of Guatemala Act contains three important provisions to provide the central bank with the autonomy that is necessary to carry out monetary, exchange and credit policy of the country. The multiple and sometimes conflicting goals of the previous legislation have been replaced by a clear focus on a single goal –the preservation of price stability. In addition, the president and the vice-president of the central bank are named by the President of the Republic for periods that do not coincide with the period of the Government. Finally, the law prohibits the central bank from financing or guarantying the financing of the government or its dependencies.
- 2.24 The law provides for a reserve requirement that is applied to both local currency deposits and deposits denominated in foreign exchange. The requirement is set at a rate that is determined from time to time by the **MB**, according to its monetary policy. The reserve reporting period **has** been reduced to a maximum of two weeks. Significant penalties are levied on banks that do not comply with these requirements. In order to avoid disintermediation for the purpose of evading the reserve requirement, the **MB** may apply the requirement to certain accounts in the non-bank entities of a financial group, if the **MB** determines that these accounts are similar to bank deposits.
- 2.25 The lender-of-last-resort powers of BANGUAT are limited to providing temporary liquidity. These advances are for a period of 30 days, renewable for an additional 15 days. The rate of interest of the advances must be higher than the average lending rate of the bank receiving the LOLR assistance. The **SB** must inform the **MB** giving the reasons for the need for liquidity and providing information about the quality of the guarantees that the bank will provide to secure the advance. In addition, the bank deposits of the government and its dependencies must be kept in accounts at the central bank, in order to give the

central bank a better monetary control and to avoid circumstances which occurred in the past when government dependencies were instructed to deposit their resources with selected banks.

- 2.26** In the past, the execution of monetary, exchange and credit policy has caused quasi-fiscal losses to accumulate in BANGUAT, reaching approximately **8%** of GDP. The new Bank of Guatemala Act requires the **SB** to conduct an audit of BANGUAT to determine the precise size of the losses. Following this, the Ministry of Public Finance will cover the losses by transferring non-negotiable bonds to BANGUAT in an amount equal to the losses. These bonds will not bear interest. While this solution to the problem is a paper one, it will solve the problem of the accumulated losses without requiring a budgetary transfer, with the related cuts in social services or increases in taxes that would have been necessary to create the space in the Government's budget.
- 2.27** The new law also establishes a "market friendly" mechanism to eliminate quasi-fiscal losses in the future. The mechanism requires BANGUAT to first debit its general reserve account for the amount of any loss during the fiscal year. If the balance in the reserve account is insufficient to cover the losses, they will be covered by the Ministry of Public Finance through the transfer of fully negotiable government bonds bearing market rates of interest.
- 2.28 Regulation and Supervision:** The Banking and Financial Groups Act together with the Financial Supervision Act create the legal figure of a "financial group". The member companies of a financial group share a high degree of common ownership that enables the principal owners of the group to exert a significant influence over the decisions of the member companies. All such groups must include a bank and they may also include a finance company, insurance company, stockbroker, bonded warehouse, and other financial companies. They may not include industrial or commercial companies. A group of related financial companies may declare to the authorities that they wish to be considered **as** a financial group. In that case, they are allowed to share resources and to commercialize their activities as an integrated organization. In exchange for this, they are regulated and supervised on a consolidated basis by the SB. The SB has access to all of the information on the operations and activities of each of the member companies. If the SB detects a high degree of joint ownership or influence in the decision-making of companies that have not declared themselves to be a financial group, it may declare the companies to be a financial group and regulate them **as** such.
- 2.29** The purpose of the new legislation is to create a legal framework that accepts the reality of related financial companies that work together and who may share some facilities or market their services as a group. This practice is common in many countries. At the same time the legislation imposes restrictions on the risk-taking activities of the group to ensure that the depositors in the bank are not exposed to losses that result from the activities of the other members of the group. In the

event that the rules are not being followed, the SB has broad sanctioning powers that can be applied.

- 2.30 Several provisions in the new legal framework are designed to reduce the importance of off-shore banking and to bring it under stricter control. The incentives for offshore banking activity have been reduced since now domestic banks can offer foreign currency accounts and grant loans denominated in foreign currency. The new legislation prohibits non-banks taking deposits from the public. In order to operate in Guatemala, an offshore institutions must agree in writing to be supervised by the SB.
- 2.31 Prudential norms have been substantially increased. Base capital is equal to 10% of risk assets, a loan classification system based on international standards is required and provisioning is risk-based. The new laws establish the responsibilities of the managers and directors of a bank and establish that the group companies must maintain a system of internal control that is adequate for the nature and the scale of their businesses. A single borrower limit of 15% of a bank's capital is established, as well as a limit of 20% for a series of loans to companies that are related (these limits are at the low end of the range for other countries in Central America). The legislation provides for transition periods for the full application of the new capitalization and provisioning requirements. These phasing-in periods are provided in order to give institutions ample time to form financial groups, to comply with the higher capital requirements or lower single borrower limits and to make other arrangements, such as mergers or acquisitions, that will help them to compete in a banking environment that requires higher levels of capital. Banks that have less than the required 10% of risk related capital when the law becomes effective must increase their capital by one percentage point per annum until they reach the required amount. Banks are given a year to reach the single borrower limit of 15% of capital for all of their borrowers, and the 20% limit on loans to related borrowers.
- 2.32 The functional independence of the SB has been substantially increased with a new sanctioning authority that allows the SB to levy and enforce fines on institutions that are not operating in accordance with the legal and regulatory framework. The legislation contains features that enable the authorities to preserve the safety and soundness of the system and of individual institutions in the system. A bank must inform the SB immediately when its capital falls below required levels and within five days the bank must enter into a restructuring program with the SB. In this way banks can be rehabilitated without the use of public funds, before they become insolvent. If an institution loses more than half of its capital, the MB is required to order the suspension of the bank's operations. The next day the MB appoints a three-member Liquidation Board that reports functionally to the SB. The Liquidation Board has the authority to recommend to the Court that the bank be liquidated, sold or merged into another, solvent institution.

- 2.33** In order to improve the quality of information in the banking system, the SB is mandated to create accounting norms for the sector and to set out the criteria that an external audit must cover. For the accounting norms, it has selected the International Accounting Standards, a set of accounting principals that is generally accepted in many countries. It also sets standards to be used for contracting external auditors and maintains a registry of qualified auditors and requires the publication and diffusion of banking information to the public.
- 2.34** The details of a financial sector program supporting the legal reforms mentioned above are set out in Section III.



### III. THE SECTOR REFORM PROGRAM - OBJECTIVES AND DESCRIPTION

#### A. Objectives and structure

- 3.1 The main objectives of Financial Sector Reform Program II are to modernize the legal framework of the banking sector and to strengthen the regulatory and supervisory entities of the system, in particular the central bank and the Superintendency of Banks.
- 3.2 The Program will be disbursed in two tranches. The approval of each of the five laws in the proposed Program is a condition for the presentation of the Program to the Bank's Board of Executive Directors. A first tranche of US\$120m will be available for disbursement upon approval of the Program by the Bank and compliance with first tranche conditions. The second tranche for US\$80m will be disbursed when the laws are fully implemented. The Program is front-end loaded to reflect the importance of enacting the new legal framework for the sector. The actions contemplated in the Program will be taken over the next 18 to 24 months.
- 3.3 The conditions for disbursement are summarized in the Policy Matrix in Annex I and described more fully in this section. The Government's Policy Letter (Annex II) sets out the authorities' commitment to the implementation of the Program.

#### 1. Conditions for the first disbursement

##### a) Macroeconomic framework

- 3.4 The Program requires the adoption of a macroeconomic stabilization program. Guatemala has requested the assistance of the IMF to help design and monitor such a program. In May 2001 the IMF commenced work on the preparation of the program, which will contain measures directed at: (i) fiscal consolidation through tax revenue measures, including the tax package already approved, improvement in tax administration, and specific measures to arrest the faster growth in expenditure recorded so far in the year; (ii) redistribution of expenditures towards social areas and towards financing the costs of bank resolutions; and (iii) specific measures to reduce corruption and improve transparency.

#### *Component I: Reforms of the Central Bank*

- 3.5 **Organic Law of the Bank of Guatemala and the Monetary Act.** The Congress has passed these two laws and they will come into effect on January 1, 2002. The laws include, among other measures, provisions to: (i) clarify the functions of the central bank and guaranty its independence in the execution of monetary, credit and exchange policy; (ii) restore its capital, and; (iii) improve the way that reserve requirements are calculated and administered. The laws: provide for a term of office for the central bank president and vice-president that does not coincide with the period of Government; define the stability of prices as the main goal of

the central bank, prohibit the financing of the government by the central bank; simplify the reserve requirements; and give the central bank the flexibility needed to set the reserve requirements according to the requirements of monetary policy. The laws also contain measures for the Government to cover the accumulated losses of BANGUAT and to cover future losses, should they occur.

- 3.6 Free Negotiation of Foreign Exchange Law.** The Congress has passed this law and it is in effect. The law eliminates restrictions on the ownership of foreign exchange and permits contracting in foreign exchange. (The Quetzal remains the official currency of Guatemala.)

*Component II: Reforms of the Banking System*

- 3.7 Banking and Financial Groups Act and the Financial Supervision Act.** The National Congress has passed these laws and they come into effect on January 1, 2002. They work together to: (i) prohibit intermediaries that are not regulated by the SB, other than credit unions and other entities which are regulated by their own law, from capturing deposits from the public; (ii) establish adequate levels of capitalization and procedures for the risk management of banks and financial groups; (iii) require the consolidated supervision of financial groups, including the off-shore companies; (iv) strengthen the SB's functional independence and establish adequate legal protection for the staff of the SB when carrying-out their functions; (v) establish an efficient and effective system for applying sanctions; (vi) establish a regime for institutions with solvency problems that includes provisions for the regularization of their activities, the suspension of operations, and the liquidation of insolvent entities; (vii) require the SB to set out the accounting norms applicable to the banking sector; (viii) require the SB to establish the scope of bank's external auditing, the minimum requirements for the contracting of auditors, and the creation of an auditors' registry; and (ix) require the publication and dissemination of bank information.
- 3.8 Plan of action for the implementation of the Banking and Financial Groups Act and the Financial Supervision Act.** The SB has submitted a plan of action to transition to the new legal framework. This plan includes steps to: (i) implement the new system of risk management; (ii) move to consolidated supervision; (iii) adopt the International Accounting Standards and new auditing norms; (iv) define the scope of the external audits; (v) specify the method of contracting of external auditors; and (vi) establish the registry of auditors. The action plans includes specific benchmarks to measure the progress of implementation. Compliance with the benchmarks in this plan are conditions for the second disbursement.

## 2. Conditions for the second disbursement

### a) Macroeconomic framework

- 3.9 GGU has implemented the macroeconomic stabilization program satisfactorily in accordance with the benchmarks of the program.

Documents provided by the IMF will be used to measure performance under the macroeconomic stabilization program.

#### *Component I: Reforms of the Central Bank*

- 3.10 **Organic Law of the Bank of Guatemala, the Monetary Act, and the Free Foreign Exchange Negotiation Act.** The Government will provide evidence that all of the implementing regulations to these laws have been issued, that the laws are being fully applied, and that the independence of the central bank in the execution of monetary, exchange and credit policy is being respected. **Plan for the recapitalization of the central bank,** The Government will provide evidence that the Ministry of Public Finance has covered the accumulated deficit of the Bank of Guatemala and is applying the law regarding future losses.

#### *Component II: Reforms of the banking system*

- 3.11 **Banking and Financial Groups Act and the Financial Supervision Act,** The Government will provide evidence that the norms regulating the Bank and Financial Groups Act and the Financial Supervision Act have been issued and that the laws and norms are being fully applied.
- 3.12 **Plan of action for the implementation of the Banking and Financial Groups Act and the Financial Supervision Act.** The Government will provide evidence that the benchmarks of the plan of action (contained in Annex III) have been met. The benchmarks will cover: (i) the implementation of the new system of **risk** management; (ii) the consolidated supervision of financial groups; and (iii) the adoption of new accounting and auditing norms.

## **IV. FINANCING AND EXECUTION**

### **A. Financing**

- 4.1 The total amount of the loan to support the proposed sector Program is US\$200 million. The resources will be disbursed in two tranches. The policy conditions for the first tranche (US\$120m) have already been met. Accordingly, the tranche will be available for disbursement following the signing of the loan contract and the ratification of the operation by the Guatemalan Congress. The second tranche of US\$80 million would be available for disbursement upon compliance with the conditions set out in the policy matrix. It is expected that the conditions for the disbursement of the second tranche would be met within a period of 18-24 months from the date the operation is approved by the Bank

### **B. Borrower and executing agency**

- 4.2 The Borrower will be the Republic of Guatemala. The Ministry of Public Finance, the Bank of Guatemala and the Superintendency of Banks will act as the executing agencies. The MPF will be responsible for verifying that the conditions of the loan contract are being complied with and for submitting documentation to the Bank demonstrating compliance with the conditions when the disbursements are requested.

### **C. Disbursement procedures.**

- 4.3 The sector loan resources will be used to finance, among other things, the costs of eligible imports from the Bank's member countries. The Bank's simplified procedure for sector loans shall apply, as established in Document GN-2001-2. Funds shall be disbursed for the Borrower's use upon request through simple application and presentation of acceptable evidence of compliance with all contractual conditions.
- 4.4 The conditions of the Program for each disbursement are described in section III of this document and presented in a more summarized form in the Policy Matrix (Annex I). These conditions will also be reflected in the Loan Contract. The authorities describe their commitment to implement the reform program in the Policy Letter (Annex 11).

### **D. Inspection and supervision**

- 4.5 The Bank has the right to inspect and supervise the execution of the Program as frequently as necessary to ensure the satisfactory execution of the Program. This includes the right to request financial reports on the use of the resources, audited by a firm of auditors previously approved by the Bank. The Borrower has agreed to cooperate fully in providing access to the information that is required to inspect and supervise the Program's execution and to provide such other assistance as the Bank may require in this regard.

**E. Ex-post evaluation**

- 4.6** The Country Office will prepare a Project Completion Report (PCR) when the Program has been fully executed. The borrower has agreed to conduct an ex-post evaluation of the Program within two years after the second disbursement. The PCR will be shared with the Borrower as background for the Borrower's ex-post evaluation of the Program. The structure of ~~this~~ ex-post evaluation will be agreed with the Bank.

**F. Environmental and social impact**

- 4.7** The activities of the proposed program are limited to legal reforms of the financial sector. Consequently, no environmental impact is expected. The Committee on Environmental and Social Impact reviewed the Profile II of the operation in its meeting of June 8, 1999 and concluded that it **was** not necessary to prepare an assessment of the environmental or social impact of the proposed Program. The Program does have an important indirect social benefit, however, since it will help protect small savers and will reduce the risk **of** a potentially devastating financial crisis. The project does not contain performance indicators to measure poverty reduction and social equity enhancement.

## **V. MONEY LAUNDERING**

- 5.1 The overly permissive regulatory environment that characterized the recent past also affected Guatemala's ability to control money laundering. In June, 2001 the Financial Action Task Force (FATF) published a report on money laundering in Guatemala. Their findings are based on the legal framework that existed before the reforms contained in the proposed operation were passed into law. The report found that Guatemalan laws contained provisions that made it difficult for the authorities to effectively address and control money laundering activities. As a result, the FATF placed Guatemala on its list of "non-cooperative" countries.
- 5.2 Many of the concerns raised by the FATF are directly addressed in the new banking legislation. In their report, the FATF cited concerns over the ineffective regulation and supervision of all financial institutions; the ability of unauthorized financial institutions to operate in the country; the lack of fit and proper criteria for owners and managers of financial institutions; and legal or practical obstacles to access by administrative and judicial authorities to information regarding the identity of account holders. All of these issues are directly addressed and corrected by the banking legislation supported in the proposed Program.
- 5.3 The Guatemalan authorities were concerned about the money laundering issue even before the FATF report was released and have been taking steps to control it. In early May 2001 the Monetary Board issued the Regulation for the Detection and Prevention of Money Laundering (ML). These Regulations significantly improve Guatemala's ability to implement customer identification procedures. The issuance of the regulations was followed by a seminar with the banking community hosted by the Superintendent of Banks. The SB staff made presentations concerning the regulations, and the political and economic consequences to the country of being identified as a non-cooperating country. They also presented case studies to help banks identify money laundering transactions. To further emphasize the importance of the issue, BANGUAT held a seminar with the banks later in the month. In parallel, the Executive, in cooperation with BANGUAT and the SB, has prepared a law prohibiting money laundering. This law, which reflects many of the recommendations of the Organization of American States (OAS) experts on money-laundering<sup>7</sup> has recently been passed by the Congress. Lastly, the Banking and Financial Groups Act supported by the proposed operation will also help the authorities in their efforts to control money laundering by creating a more rigorous supervisory environment that includes for the first time the supervision of the off-shore banks.
- 5.4 These initiatives continue. The Bank is preparing a technical assistance operation for the Ministry of Public Finance that contains three activities related to money laundering. This TC will analyze aspects of Guatemalan legislation that need to be changed to close the loopholes that the new banking legislation and the ML law do not reach, it will design an intelligence unit within the Ministry to deal with money laundering issues, and it will produce terms of reference for a training

program for the Superintendency of **Banks** in the application of the new law. These terms of reference will serve **as** an input into the MIF TC for the **SB**, mentioned several times in this document and will include a component to implement the training program described in the terms of reference. The **U.S.** Government and the **OAS** is also providing support in this area.

- 5.5** In conclusion, although the proposed Program does not have specific components dealing with the ML issue, it provides an opportunity to summarize what Guatemala is doing to stop it. These initiatives include: (i) the passing of a ML law; (ii) the regulation of this law, plus earlier regulation designed to control ML before the new law is enacted; (iii) seminars to educate the banking community in the issue; (iv) the examination of other laws to further close loopholes; (v) the establishment of a unit in the Ministry of Public Finance to apply the new law; (vi) training of the staff of the **SB**; and (vii) the new legal framework for the banking sector supported by this Program which contain many provisions that directly address many of the points raised by the FATF.

## **VI. BENEFITS AND RISKS**

### **A. Benefits**

- 6.1 As has been explained earlier in this Loan Document, the institutions that are the focus of this program, BANGUAT and the **SB**, are technically strong. However, they have not been able until recently to exercise their technical strengths in the implementation of monetary and exchange policy or in the regulation and supervision of the banking sector because of weaknesses in the legal framework. The new framework supported by the proposed program provides these institutions with the firm foundation that they need to accomplish their functions.
- 6.2 The Banking and Financial Groups Act and the Financial Supervision Act contain measures to substantially reduce unregulated financial intermediation, improve risk management, promote consolidated supervision, strengthen the functional independence of the **SB**, create disincentives for bad behavior, resolve problem banks, create new accounting norms and improve auditing practices. The overall effect of the implementation of the principles contained in these two laws is to lower the risks in the financial system and to reduce the likelihood of individual bank failures or of a more generalized banking crisis. Experience in other countries has shown a strong correlation between reduced systemic risks and lower interest rates. Thus the implementation of this Program could have the additional benefit of lowering the cost of capital in Guatemala and increasing capital investment.
- 6.3 The Organic Law of the Bank of Guatemala and the Monetary Act increase the autonomy of the central bank and provide it with more clearly delineated functions and goals and help to strengthen its capital base. It also modernizes the system of reserve requirements and clarifies the central bank's lender of last resort function. These improvements will help the central bank to maintain a stable monetary policy, which will help to lower interest rates and to stabilize the exchange rates.
- 6.4 The Free Negotiation of Foreign Exchange Act permits people to hold foreign exchange and even permits them to contract in foreign exchange if the parties so desire. This reduces the incentives for sending capital abroad and recognizes the basic freedom of economic agents to conduct their economic affairs without undue restrictions from the government.
- 6.5 Lastly, the resources contained in the proposed Program will provide a cushion of international reserves that should help the monetary authorities to confront the fiscal deficits that are presently occurring, partly **as** a result of past policy failures. While all of these effects will not be perceived immediately, the overall effect can be expected to be substantial, provided that the authorities are permitted to exercise their new and more clearly delineated powers.



**B. Risks**

- 6.6** The composition of the Monetary Board, presents a political risk to the reforms. The executive branch, the Congress and business interests are represented on this Board, something that has given rise to political criteria being used instead of technical criteria in the taking of some important decisions. Since the composition of the Board is determined by the Guatemalan constitution, it has not been changed by the proposed Program. The provisions of the new legal framework, particularly the devolution of sanctioning powers to the **SB**, the increased independence of the central bank and the more clearly delineated framework for the implementation of monetary policy, should make it easier for the MB to make decisions on technical and not on political grounds.
- 6.7** The problem of judicial security is also a serious political risk to the success of the Program. Under the previously existing legal framework some obstacles were put in the path of the authorities during the bank interventions that are presently being completed. The reform measures themselves should reduce judicial arbitrariness by making the rules of the game more clear and by eliminating several loopholes. It will not solve the problem, however.
- 6.8** Lastly, the front-end loaded package of legal reforms eliminates the problem of incomplete measures that has been a problem in many sector loan programs that had tranching legal reform components.

POLICY MATRIX (GU-0119)

Objectives	First Tranche	Second Tranche
To develop a stable macroeconomic environment	Guatemala has adopted a Macro-economic stabilization program consistent with the objectives of the Program.	Satisfactory performance of the macro-economic stabilization program.

Objectives	First Tranche	Second Tranche
Strengthening of the Central Bank and the instruments of monetary policy	<p>1. Organic Bank of Guatemala Act and Monetary Act reflecting technical criteria agreed with the Bank, approved by Congress and in effect. These laws should contain measures to:</p> <ul style="list-style-type: none"> <li>(i) clarify the functions of the Central Bank and guaranty its independence to execute the monetary, exchange and credit policy of the country</li> <li>(ii) restore its capital through the absorption by the MFP of the accumulated deficit of the Central Bank and the requirement that future deficits also be covered by the MFP.</li> <li>(iii) modernize the reserve requirements.</li> </ul> <p>2. Free Foreign Exchange Negotiation Act to remove restrictions on the ownership of and contracting in foreign exchange approved by Congress and in effect in accordance with the technical criteria agreed with the Bank.</p>	<p>1. (i) The Government will provide evidence that the implementing regulations to the Organic Bank of Guatemala Act, the Monetary Act, and the Free Foreign Exchange Negotiation Act have been issued, that the laws are being fully applied, and that the independence of the central bank in the execution of monetary, exchange and credit policy is being respected.</p> <p>(ii) Evidence that the Ministry of Finance has covered the accumulated deficit of the CB and is applying the law regarding possible future losses.</p>

OBJECTIVES	FIRST FRANCHISE	Second Franchise
Strengthening the Legal and regulatory framework for bank supervision.	<p>1. Bank and Financial Groups Act and the Financial Supervision Act approved by Congress and in effect, in accordance with the technical criteria agreed with the Bank: These laws should include provisions to:</p> <ul style="list-style-type: none"> <li>(i) Prohibit intermediaries that are not regulated by the SB, other than credit unions and other entities which are regulated by their own law, from capturing deposits from the public;</li> <li>(ii) Establish adequate levels of capitalization and of risk management of banks and financial groups;</li> <li>(iii) Require the consolidated supervision of financial groups, including the off-shore companies;</li> <li>(iv) Strengthen the SB's functional independence and which establish of adequate legal protections of the staff of the SB when carrying out their functions</li> <li>(v) Establish an efficient and effective system for applying sanctions;</li> <li>(vi) Establish a regime for institutions with solvency problems that includes provisions for the regularization of their activities, the suspension of operations and liquidation of insolvent entities;</li> <li>(vii) Require the SB to set out accounting norms applicable to the banking sector;</li> <li>(viii) Require the SB to establish the scope of banks' external auditing, the minimum requirements for the contracting of auditors and the formation of an Auditors' Registry;</li> <li>(ix) Require the publication and dissemination of bank information.</li> </ul> <p>2. The SB has submitted a plan of action to transition to the new legal framework. This plan includes steps to:</p> <ul style="list-style-type: none"> <li>(i) Implement the new risk management system,</li> <li>(ii) Move to consolidated supervision,</li> <li>(iii) Adopt the International Accounting Standards and new auditing norms, define the scope of external audits, specify the method of contracting of external auditors, and establishing the Registry of Auditors.</li> </ul>	<p>The Government will provide evidence that the implementing regulations to the Bank and Financial Groups Act and the Financial Supervision Act have been issued and are in use, in accordance with the technical criteria agreed with the Bank.</p> <p>The Government will provide evidence that the benchmarks of the SB's action plan, contained in Annex III, have been met.</p>

**Guatemala**  
**Financial Sector Reform Program, Phase II**  
**Policy letter**

6 November 2001

Mr. Enrique Iglesias  
President  
Inter-American Development Bank  
Washington, D.C.

Dear Mr. Iglesias,

The political and institutional environment of today, in conjunction with current global economic conditions, have led the Government of Guatemala to implement, rapidly but coherently, a new strategy of effective economic policy.

Among the necessary reforms, strengthening the financial sector is one of the greatest challenges given the importance of improving resource allocation **as well as** broadening and democratizing financing sources to meet investment needs in both the public and private sectors.

***I. The macroeconomic framework***

Since the early 1990s Guatemala has been implementing structural reforms to reduce both internal and external economic disequilibria and promote economic stability together with a significant and sustained recovery of economic activity.

Economic stability is a necessary condition for implementing effective social policy that will help support democratic society and for putting in place reforms to boost economic growth, reduce poverty, and bring about social progress.

Against this backdrop, the design of monetary, exchange and credit policy has endeavored to achieve price stability to bring confidence to savers and investors.

Since 1991, monetary management has focused on bringing inflation down to single digits. This rate averaged 6.1% during the period 1997-2000, and is expected to be **8%** for 2001. Although that rate is above the target set by monetary authorities (4%-6%), it reflects the one-time adjustment of a two percentage-point increase in value-added tax approved under the recent tax reform. Price stability has generated confidence and certainty among economic agents, helping to maintain growth rates of between 3% and 5% in the past **10** years. For 2001, despite an unfavorable external environment, growth is expected to continue to be positive at around 2.3%.

The fundamental underpinning of the stable and viable economic growth pursued by the authorities is coherent and effective economic policy. Accordingly, in addition to maintaining pricing discipline, fiscal discipline **has** been strengthened with the approval of a comprehensive reform that calls for reinforcing collection capacity **through** tax and penal code reforms, as well **as** tax reforms. The latter include the increase in sales **tax** from 10% to 12%, which will allow the **tax** load to be raised to 12% **as** established in the peace agreements.

It is important to keep in mind that macroeconomic stabilization policies must be supported by structural reforms that seek to promote efficiency **through** a more open and deregulated economy. Vital in this sense is the creation of an enabling environment for domestic and foreign investment by setting up a clear, predictable judicial framework to guarantee competition and promote productivity gains.

Among the structural reforms undertaken is the strengthening of the domestic financial system. A more agile, efficient and versatile financial system is a sine qua non for promoting domestic saving channeled into financing more productive investments to create jobs, generate production, and generally bring progress and well-being to all Guatemalans.

## ***II. Program to strengthen the financial system***

The basic structure of financial legislation in Guatemala dates back to 1945 and 1946, when the Bank of Guatemala Act, the Monetary Act and the Banking Act were adopted. The sweeping changes that have occurred since then in international financial markets and modern practices in monetary and financial policy have pointed up the need to have a regulatory framework more in tune with current and future realities. Accordingly, the objective of the efforts deployed in Guatemala, which are to be continued and deepened, is to strengthen the national financial system and make it less vulnerable to financial instability and crisis – phenomena that have multiplied to the point where they are now one of the major sources of macroeconomic instability and loss of well-being.

The Guatemalan government's conviction that efficiency and versatility in the financial sector are important goals has led the country's authorities to back a strengthening process. The Monetary Board, on 1 June 2000, approved the National Financial System Strengthening Program, laying the groundwork for a new legal framework governing financial transactions in Guatemala. The new legislation is in tune with an environment of financial globalization.

The comprehensive reform of Guatemalan financial legislation includes five laws:

- 1) The Bank of Guatemala Act
- 2) The Monetary Act
- 3) The Banking Act
- 4) The Financial Supervision Act

5) The Free Exchange Transactions Act

- 1) **The Bank of Guatemala Act** is intended to overcome the weaknesses of the current legal framework by strengthening central bank autonomy (both from an economic and financial and from a political point of view) and the credibility of actions by the monetary authority. This strengthening will contribute to making monetary policy more effective in meeting its fundamental objective: achieving and maintaining general price stability.

To ~~this~~ end, the act aims to strengthen the central bank's autonomy and credibility on the basis of four pillars:

- a) *Clarity of the basic objective*, which will not only facilitate achieving it but also lead to setting up appropriate accountability;
  - b) *Political autonomy*, given that most countries with a modern central bank provide them with independent instruments. To this end, the term of central bank authorities' tenure will not coincide with that of the executive branch, and provisions for their removal are strictly judicial in nature and clearly set forth to avoid any political interference;
  - c) *Economic and financial autonomy*, respecting the ban on central banks extending credit to governments; in addition, the regulations clearly stipulate the relationship and relative functions of the central bank and the government, including in particular that the State is to absorb the cumulative cost of executing monetary, exchange and credit policy in the country, as well as the future treatment of annual losses or gains by the central bank and maintenance of its capital by the government;
  - d) *Transparency and strengthening of accountability*, to disclose to the public, in a comprehensible, accessible, and timely manner, the objectives of monetary policy, its legal and institutional framework, monetary policy decisions and their reasons, information relating to monetary policy, and the conditions of central bank accountability. In addition, the act calls for central bank authorities to appear before Congress twice a year to report on the conduct of monetary policy and the status of related objectives.
- 2) **The Monetary Act**, by constitutional mandate, complements the Bank of Guatemala Act as the legal framework governing all matters relating to the central bank. It contains monetary provisions to build confidence among economic agents and to provide legal assurances for foreign exchange operations they may effect in Guatemala. Accordingly, the act includes provisions relating to the national currency, its issue and legal tender, as well as currency swaps and repayments, as well as the free external convertibility of the national currency, capital mobility, and the country's international monetary reserves.
  - 3) **The Banking Act** is intended to strengthen the Guatemalan financial system and supervision thereof by furnishing an overall legal framework that provides legal

assurances and contributes to the efficiency, soundness, transparency and competitiveness of financial institutions under a preventive approach. **This** is meant to contribute to national economic development and build up the confidence of the saving and investing public. The **aim** is to promote the development of an agile, modern and flexible banking system that can adapt to changing conditions in the environment in which it operates.

The act provides legal assurances and promotes efficiency, transparency and competitiveness in the country's financial activities by setting up sound risk management consistent with supervisory activity and market discipline, as well as stipulating the treatment of unregulated financial intermediaries. This legislation also covers the regulation of financial groups, covering such important issues **as** the expansion of banking operations, consolidated supervision and a special regime for bank restructuring or liquidation. Provisions on these issues target bringing financial legislation up to date and making financial intermediation more efficient.

- 4) **The Financial Supervision Act** confers functional independence on the Bank Superintendent, authorizing it to exercise broad oversight and inspection with free access to all sources and information systems in the subject institutions.

The act authorizes the Bank Superintendent to perform oversight and inspection functions on the basis of consolidated supervision, with the right to require subject institutions to provide information on their activities, legal acts, trust operations, and financial position, either individually or, where appropriate, in the aggregate.

The Bank Superintendent is authorized to levy penalties in support of its oversight activities.

- 5) **The Free Exchange Act** entered into effect on 1 May 2001. **This** legal framework has made it possible to legalize financial intermediation in foreign currencies, has helped eliminate transaction costs in customary foreign trade and tourism operations and, consequently, has facilitated diversification of investment and saving decisions by economic agents. The act gives Guatemalans the freedom to convert the national currency to foreign currencies through transactions of any kind – a fundamentally important aspect also covered in the Monetary Act. **This** legislation also permits mutually agreed payment of wages and salaries in foreign exchange.

- 6) **Other:** Advances in regulatory framework to prevent money laundering

In addition to the foregoing, and in support of the financial reform, significant efforts have been carried out to prevent money laundering in Guatemala.

In recent years the steps taken by the Guatemalan authorities to eradicate money laundering have included legal provisions and the signing of several agreements and international treaties.

On 23 September 1992, the Congress issued Decree 48-92 containing the Narcotrafic Act. The act creates the Commission against Drug Addiction and Illegal Traffic in Narcotics, reporting directly to the Vice President. This Commission considers and sets forth national policy for the prevention and treatment of drug addiction and for the prevention of illicit narcotrafficking in all its forms **as well as** related activities.

On 11 July 1997 the Guatemalan Minister of External Relations, together with his counterparts in the other countries of Central America and Panama, signed the “Central American Agreement for the Prevention and Repression of Money Laundering and Assets relating to Illicit Traffic in Drugs and Related Offenses”. The agreement sets forth the commitment of signatory states to take steps to include in their legislation money laundering and drug trafficking offenses, **as well as** all other fraudulent activities linked to organized crime.

On 6 November 1997, the “Agreement between Central America and the Dominican Republic for the Prevention and Repression of Money Laundering and Assets relating to Illicit Traffic in Drugs and Related Offenses” was signed in Santo Domingo. The agreement calls for harmonizing the legislation of Central American countries with the United Nations Convention against Illicit Traffic in Narcotic Drugs and Psychotropic Substances and the model of legislation promoted by the United Nations International Drug Control Programme (UNDCP).

On 25 April 2001, the Monetary Board approved the “Regulations for the Prevention and Detection of Money Laundering”, protecting the country’s regulated financial institutions from being used to transfer or deposit funds obtained from illicit activities relating to money laundering. To enable the banks to implement these provisions more effectively, the Bank Superintendent organized a seminar on 14 May 2001 to show participants how to identify suspicious transactions. Discussions covered the fact that if Guatemala was not among those countries cooperating in combating money laundering this would have an adverse financial effect on the banking sector **as well as** political and economic consequences for the country. The Bank of Guatemala also held a seminar for the banks on 23 and 24 August 2001 to reinforce implementation of the provisions.

Finally, on 29 October 2001, **as** a matter of national urgency, the Congress approved the Money Laundering and Related Assets Act, which is set forth in Decree 51-2001 of that date.

### ***III. Support from the Inter-American Development Bank***

The Government of Guatemala is committed to carrying out the National Financial System Strengthening Program out of a conviction that it will improve competitiveness and efficiency within the financial sector. The major progress made *so far* and the processes proposed to achieve the stated objective will have a positive effect on the Guatemalan financial sector by improving resource allocation, increasing savings and lowering the cost of financial intermediation. By continuing to pursue these avenues, the Government



undertakes to maintain a stable macroeconomic framework that will foster growth and economic development.

**Efforts** to date include primarily an evaluation of the financial system **as** part of the Financial Sector Assessment Program carried out by the International Monetary Fund, the World **Bank**, and the Inter-American Development **Bank**, the recent intervention and imminent resolution of three troubled banks, drafting and tabling in Congress of the legislation mentioned, and negotiation **of** a macroeconomic program with the IMF. In view **of** these efforts and upcoming initiatives under the financial sector strengthening program, in particular those associated with implementing the legal framework described herein and continued restructuring of the Guatemalan financial sector, the Government requests your favorable consideration of a loan in support of these objectives.

## **BENCHMARKS FOR THE APPLICATION OF THE BANKING AND FINANCIAL GROUPS ACT AND THE FINANCIAL SUPERVISION ACT**

At the recommendation of the Superintendency of Banks, the Monetary Board has approved three action plans that will guide the SB in the application of the new legal framework. The action plans are in the following areas:

1. Transitioning to the new system of risk management
2. Transitioning to the new system of consolidated supervision
3. Establishing the new accounting and auditing norms

The action plans contain a number of benchmarks that will be used to monitor the progress in the execution of the action plans. Additionally, the achievement of these benchmarks is a condition for the disbursement of the second tranche of the Financial Sector Loan.

### **OVERALL BENCHMARK**

The Government will provide evidence that the implementing regulations to the Bank and Financial Groups Act and the Financial Supervision Act have been issued and are in use, in accordance with the technical criteria agreed with the Bank.

### **I RISK MANAGEMENT BENCHMARKS**

1. All of the banks of the system have formed risk management committees and these committees have been approved by the SB.
2. All of the banks of the system have risk management manuals and these have been verified by the SB.
3. The banks of the system are complying with the norms for risk-based capital. (In the case of the banks that are not complying with the capital norms, the SB will provide evidence showing that they have entered into a restructuring program or that their activities have been suspended.)
4. All of the banks of the system have been inspected in accordance with the new legal framework and regulations and sanctions are being applied to institutions that are not complying with the new legal framework and regulations. (The SB will provide a statement affirming compliance with this point.)

### **II. CONSOLIDATED SUPERVISION BENCHMARKS**

1. At least 7 financial groups have been qualified by the SB and have had at least one complete inspection applying the principals of consolidated supervision.
2. At least 7 off-shore banks have been qualified by the SB or have stopped operating in Guatemala or have been cited for operating illegally.

### **111. ACCOUNTING AND AUDITING BENCHMARKS**

1. The accounting manual for bank operations adopting the International Accounting Standards has been drafted and approved by the MB.
2. All of the banks and finance companies in the system have adopted and are utilizing the new accounting norms. (The SB will provide a statement affirming compliance with this point.)
3. Register for external auditors functioning in the SB.